

IN THE  
**Supreme Court of the United States**

NOVEMBER TERM, 1978

No. 78- 869

In the Matter of  
STIRLING HOMEX CORPORATION,

*Debtor.*

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY,  
HARRY E. JONES, ALECK GOLDBERG, as Custodian for MARK  
GOLDBERG, and MRS. D. WINDSOR DIXON,

*Petitioners,*

—versus—

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN FIRST  
BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MAN-  
HATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF  
CHICAGO; MARINE MIDLAND BANK; THE TRAVELERS IN-  
DEMNITY COMPANY; and THE SECURITIES AND EXCHANGE  
COMMISSION,

*Respondents.*

**PETITION FOR A WRIT OF CERTIORARI TO  
THE UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT**

ROBERT B. BLOCK  
*Attorney for Petitioners*  
295 Madison Avenue  
New York, New York 10017  
(212) 532-4800

POMERANTZ LEVY HAUDEK & BLOCK  
MILBERG WEISS BERSHAD & SPECTHRIE  
BADER & BADER  
of New York City,

*Of Counsel*

November 13, 1978

## TABLE OF CONTENTS

---

	PAGE
Opinions Below .....	1
Jurisdiction .....	2
Question Presented .....	2
Statutes and Rule Involved .....	2
Statement of the Case .....	3
Reasons for Granting the Writ .....	4
1. As creditors, petitioners are entitled to participate <i>pro rata</i> in the insolvent debtor's distributable assets .....	6
2. Equitable subordination of claims of innocent creditors, sanctioned below, conflicts with rulings of this Court and of other circuits .....	7
3. The decisions below are impermissible judicial legislation .....	11
Conclusion .....	13
APPENDIX A—Opinion of the Court of Appeals ....	1a
APPENDIX B—Judgment of the Court of Appeals ..	20a
APPENDIX C—Decision of the Court of Appeals Denying Petition for Rehearing .....	22a
APPENDIX D—Opinion of the District Court .....	24a

## TABLE OF CITATIONS

## Cases

<i>Barlow v. Budge</i> , 172 F. 2d 440 (8th Cir.), cert. den. 317 U.S. 647 (1942) .....	10
<i>Branding Iron Steak House, In re</i> , 536 F. 2d 299 (9th Cir. 1976) .....	10
<i>Clark v. Boston-Continental Bank</i> , 84 F. 2d 605 (1st Cir. 1936) .....	7
<i>Comstock v. Institutional Investors</i> , 335 U.S. 211 (1947) .....	10
<i>Florida Land and Imp. Co. v. Merrill</i> , 52 Fed. 77 (5th Cir. 1892) .....	7
<i>GAC Corporation, In re</i> , No. 76-131-Bk-NCR-H (S.D. Fla.) .....	5
<i>Heiser v. Woodruff</i> , 327 U.S. 726 (1945) .....	9
<i>Home Stake Production Co., In the Matter of</i> , No. 73 B 922 (N.D. Okla.) .....	5
<i>Investors Funding Corporation of New York, In the Matter of</i> , Nos. 74 B 1455, 74 B 1511-1542 (S.D. N.Y.) .....	5
<i>Kenneally v. Standard Electronics Corp.</i> , 364 F. 2d 642 (8th Cir. 1966) .....	10
<i>Meinhard v. Salmon</i> , 249 N.Y. 458, 164 N.E. 545 (1928) .....	12
<i>Mobile Steel Co., In the Matter of</i> , 563 F. 2d 692 (5th Cir. 1977) .....	10, 11
<i>Nathanson v. National Labor Relations Board</i> , 344 U.S. 25 (1952) .....	7
<i>Omega-Alpha, Inc., In the Matter of</i> , No. BK 3-74-454-G (N.D. Tex.) .....	5

<i>Oppenheimer v. Harriman National Bank and Trust Co.</i> , 301 U.S. 206 (1937) .....	6, 7, 9
<i>Palisades-On-The-Desplaines, In re</i> , 89 F. 2d 214 (7th Cir. 1937) .....	6
<i>Pepper v. Litton</i> , 308 U.S. 295 (1939) .....	8
<i>Protective Committee v. Anderson</i> , 390 U.S. 414 (1968) .....	6
<i>Richardson v. Olivier</i> , 105 Fed. 277 (5th Cir. 1900) ..	7
<i>Salter v. Williams</i> , 244 Fed. 126 (3rd Cir. 1917), app. dismd. 250 U.S. 653 (1919) .....	7
<i>Scherk v. Newton</i> , 152 F. 2d 747 (10th Cir. 1945) ....	6
<i>Schwartz v. Mills</i> , 192 F. 2d 727 (2nd Cir. 1951) ....	10
<i>Spach v. Bryant</i> , 309 F. 2d 886 (5th Cir. 1962) .....	10
<i>Tcherepnin v. Knight</i> , 389 U.S. 332 (1967) .....	6
<i>Thermo-Dyne, Inc., In re</i> , No. BK 78-00272 (W.D. Okla.) .....	5
<i>U.S. v. Stirling</i> , 571 F. 2d 708, cert. den. U.S. (1978) .....	3

## Statutes and Rules

## Bankruptcy Act

§ 2, 11 U.S.C. § 11 .....	2
§ 65, 11 U.S.C. § 105 .....	2, 6
§ 106, 11 U.S.C. § 506 .....	3, 6
§ 197, 11 U.S.C. § 597 .....	3
§ 216 (10), 11 U.S.C. 616(10) .....	4
Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat.—	
§ 510(b) .....	5
Sec. 402(a) .....	5
Sec. 403(a) .....	5

	PAGE
Bankruptcy Rule 10-302(a) .....	3
National Bank Act .....	6

*Congressional Material*

H.R. Rep. No. 95-595, 95th Cong. 1st Sess., pp. 194-5 (1977) .....	7
---	---

*Miscellaneous*

6A <i>Collier on Bankruptcy</i> , ¶ 9.13, p. 238 .....	6
J.J. Slain and H. Kripke, <i>The Interface Between Securities Regulation and Bankruptcy-Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors</i> , 48 N.Y.U. L. Rev. 261 (1973) .....	7, 12

IN THE

**Supreme Court of the United States**

**November Term, 1978**

No. 78-

---

In the Matter of  
STIRLING HOMEX CORPORATION,  
*Debtor.*

---

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY,  
HARRY E. JONES, ALECK GOLDBERG, as Custodian for MARK  
GOLDBERG, and MRS. D. WINDSOR DIXON,  
*Petitioners,*

—versus—

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN FIRST  
BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MAN-  
HATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF  
CHICAGO; MARINE MIDLAND BANK; THE TRAVELERS IN-  
DEMNITY COMPANY; and THE SECURITIES AND EXCHANGE  
COMMISSION,  
*Respondents.*

---

**PETITION FOR A WRIT OF CERTIORARI TO  
THE UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT**

Petitioners, who were claimants-appellants below, pray  
for a writ of certiorari to review the judgment of the  
Second Circuit entered June 19, 1978.

**Opinions Below**

The opinion of the Second Circuit (1a) is reported at  
579 F. 2d 206 (1978). The opinion of the District Court for  
Western New York (24a) is unreported.



### Jurisdiction

The judgment of the Second Circuit (20a) was dated and entered June 19, 1978. A timely petition for rehearing was denied August 17, 1978 (22a). Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

The jurisdiction of the District Court rested on § 2 of the Bankruptcy Act, 11 U.S.C. § 11.

### Question Presented

In a proceeding for the reorganization of a corporation under Chapter X of the Bankruptcy Act, should the claims of rank and file public investors, who were defrauded into purchasing worthless securities of the debtor shortly before the debtor filed under the Bankruptcy Act, be subordinated to all other unsecured claims?

Although the Bankruptcy Act provides for parity treatment of all such claims, the court below subordinated the claims of the public investors, invoking an equitable doctrine which heretofore has been applied only against claimants who, by sharp practice, stood to gain an unfair advantage over other creditors. The result, in the reorganization at bar, is to exclude thousands of innocent and defrauded public investors from all participation in the insolvent debtor's assets.

### Statutes and Rule Involved

Section 65 of the Bankruptcy Act, 11 U.S.C. § 105:

*"Declaration and Payments of Dividends. a. Dividends of an equal per centum shall be declared and paid on all allowed claims, except such as have priority or are secured."*

Section 106 of Chapter X of the Bankruptcy Act, 11 U.S.C. § 506:

"For the purposes of this chapter, unless inconsistent with the context—

(1) 'claims' shall include all claims of whatever character against a debtor or its property, except stock, whether or not such claims are provable under section 63 of this Act and whether secured or unsecured, liquidated or unliquidated, fixed or contingent."

Section 197 of Chapter X of the Bankruptcy Act, 11 U.S.C. § 597:

"For the purposes of the plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock. \* \* \*"

Bankruptcy Rule 10-302(a):

*"Classification of Claims.* For the purposes of the plan and its acceptance, the court may fix, after hearing on such notice as it may direct, the division of creditors and stockholders into classes according to the nature of their respective claims and stock."

### Statement of the Case

The debtor, Stirling Homex Corporation, filed under Chapter X of the Bankruptcy Act soon after large quantities of its shares were sold to the investing public. As noted by the Second Circuit in affirming the convictions of key officials of the debtor, *U.S. v. Stirling*, 571 F. 2d 708, 713-4, cert. den. U.S. (1978), they "engaged collectively in a calculated and multifaceted plan to give the investing

public the false impression that Homex was in a sound and steadily improving financial position and at the same time withhold adverse information that was material to an accurate appraisal of the company's prospects."

Petitioners are deceived purchasers of the debtor's securities, asserting fraud claims against the debtor. The merit of petitioners' claims is assumed in the opinion below (4a-5a) and is beyond serious question.

The Trustee, having concluded that the debtor is unable to continue operations, has been engaged in liquidating its assets for distribution to creditors. The distributable assets amount to \$17 million against claims of \$46 million, excluding those of the defrauded security purchasers which are difficult to estimate and could exceed those of all other creditors.

The opinion below (16a) makes much of the supposed reliance of ordinary general creditors on an "equity cushion" contributed by the debtor's stockholders. A significant record fact, which the opinion does not allude to, however, is that \$37 million of the claims, on the part of the present debtor's bankers, arose from loans to the debtor which were made when the debtor's equity capital was a mere \$8.5 million, before \$20 million of the debtor's preferred stock was sold to the public.

### Reasons for Granting the Writ

The ruling below deprives thousands of claimants of participation in the Chapter X reorganization of the debtor corporation. A host of claimants in other Chapter X pro-

<sup>1</sup> See Bankruptcy Act § 216(10), 11 U.S.C. 616 (10).

ceedings, in the Second, Fifth and Tenth Circuits, are in the same posture.<sup>2</sup>

Our adversaries will note that the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. (which became law with the President's signature on November 6), will eventually subordinate the claims of defrauded security purchasers; § 510(b) thereof. That statute, with immaterial exceptions, is not effective until October 1, 1979; Sec. 402(a) thereof. Moreover, it contains, in Sec. 403(a), an explicit saving provision for cases like the one at bar and the reorganizations previously cited. Thereunder such proceedings shall be conducted and determined under the pre-existing Bankruptcy Act.<sup>3</sup>

The ruling below is manifestly unsound, as will shortly appear, being in conflict with pre-existing case law made by this Court and courts below. So long as the decision in question is allowed to stand, it will extinguish or, at the least, diminish the interests of innumerable innocent claimants in the Second Circuit and, no doubt, through operation

<sup>2</sup> Such proceedings include *In the Matter of Investors Funding Corporation of New York*, Nos. 74 B 1455, 74 B 1511-1542 (S.D. N.Y.) [stockholders and debentureholders]; *In re GAC Corporation*, No. 76-131-BK-NCR-H (S.D. Fla.) [debentureholders]; *In the Matter of Omega-Alpha, Inc.*, No. Bk. 3-74-454-G (N.D. Tex.) [noteholders]; *In re Thermo-Dyne, Inc.*, No. BK 78-00272 (W.D. Okla.) [oil and gas programs]; *In the Matter of Home-Stake Production Co.*, No. 73 B 922 (N.D.Okla.) [oil and gas programs].

<sup>3</sup> The saving provision of the Bankruptcy Reform Act, so far as pertinent, is as follows:

"Sec. 403.(a) A case commenced under the Bankruptcy Act, and all matters and proceedings in or relating to any such case, shall be conducted and determined under such Act as if this Act had not been enacted, and the substantive rights of parties in connection with any such bankruptcy case, matter, or proceeding shall continue to be governed by the law applicable to such case, matter, or proceeding as if the Act had not been enacted."

of *stare decisis*, in two other circuits as well. The yet to be effective Bankruptcy Reform Act in no way moots rejection of the claims of a multitude of defrauded investors by patent disregard of currently applicable statute and decisional law.

**1. As creditors, petitioners are entitled to participate *pro rata* in the insolvent debtor's distributable assets.**

Petitioners fall within the definition of "creditor" under § 106 of the Bankruptcy Act, 11 U.S.C. § 506. The Circuit Court assumed, for purposes of its opinion, that petitioners are creditors (12a-13a).

The Act does not discriminate among unsecured or general creditors according to the manner in which their claims arose. Bankruptcy Act § 65, 11 U.S.C. § 105; *In re Palisades-On-The Desplaines*, 89 F.2d 214, 217 (7th Cir. 1937); *Scherk v. Newton*, 152 F. 2d 747, 750-51 (10th Cir. 1945); 6A *Collier on Bankruptcy*, ¶ 9.13, p. 238. As explicitly conceded in the opinion below (10a-11a), the absolute priority rule has no application inasmuch as petitioners are claiming as defrauded purchasers of the debtor's stock rather than as stockholders seeking equity distribution.

This Court addressed the issue here presented in *Oppenheimer v. Harriman National Bank and Trust Co.*, 301 U.S. 206 (1937). The defrauded shareholder in that case was accorded parity treatment with other creditors. This Court noted, at p. 215, that discrimination against stockholders' claims was not authorized by the statute there involved, the National Bank Act.<sup>4</sup>

<sup>4</sup> The Supreme Court in two later cases took note of, but did not reach, the issue of the ranking of fraud claims arising out of purchases of the debtor's stock. *Tcherepnin v. Knight*, 389 U.S. 332, 346 (1967); *Protective Committee v. Anderson*, 390 U.S. 414, 453 (1968).

(footnote continued on following page)

The same is true of the Bankruptcy Act.

"The theme of the Bankruptcy Act is 'equality of distribution' (*Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219); and if one claimant is to be preferred over others, the purpose should be clear from the statute. We can find in the Bankruptcy Act no warrant for giving these back pay awards any different treatment than other wage claims enjoy." *Nathanson v. National Labor Relations Board*, 344 U.S. 25, 29 (1952).

Similarly, in our case there is nothing to be found in the Bankruptcy Act warranting different treatment of fraud claims merely because the claimants are, or once were, stockholders.

**2. Equitable subordination of claims of innocent creditors, sanctioned below, conflicts with rulings of this Court and of other circuits.**

Subordination—rejection, in practical effect—of petitioners' fraud claims was sustained below on the strength of the doctrine of equitable subordination (13a-19a). Until the ruling below, however, the doctrine of equitable subordination was universally understood as applicable only

(footnote continued from preceding page)

*Oppenheimer* followed a number of lower court rulings to like effect. *Clark v. Boston-Continental Bank*, 84 F. 2d 605, 607 (1st Cir. 1936); *Salter v. Williams*, 244 Fed. 126, 128 (3rd Cir. 1917), *app. dismd.* 250 U.S. 653 (1919); *Richardson v. Olivier*, 105 Fed. 277, 280 (5th Cir. 1900); *Florida Land and Imp. Co. v. Merrill*, 52 Fed. 77, 80-1 (5th Cir. 1892).

*Oppenheimer* is recognized as the law of the land, even by those who disagree with it. See J.J. Slain and H. Kripke, *The Interface Between Securities Regulation and Bankruptcy-Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. Rev. 261, 284 (1973); H. R. Rep. No. 95-595, 95th Cong. 1st Sess., pp. 194-5 (1977).



against claimants who otherwise would gain an unfair advantage through their having engaged in some type of inequitable conduct which injured the bankrupt or its other creditors.

The scope, hence the limitations, of the equitable subordination principle is well delineated in *Pepper v. Litton*, 308 U.S. 295, 307-9 (1939), the leading authority on the doctrine which, we submit, was egregiously misapplied by the court below (13a-14a):

"As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claim in bankruptcy. In the exercise of equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director or stockholder. That is clearly the power and duty of the bankruptcy courts under the reorganization sections. In *Taylor v. Standard Gas & E. Co.* 306 US 307, this Court held that the claim of Standard against its subsidiary (admittedly a claim due and owing) should be allowed to participate in the reorganization plan of the subsidiary only in subordination to the preferred stock of the subsidiary. This was based on the equities of the case—the history of spoliation, mismanagement, and faithless stewardship of the affairs of the subsidiary by Standard to the detriment of the public investors. Similar results have properly been reached in ordinary bankruptcy proceedings. Thus, salary claims of officers, directors and stockholders in the bankruptcy of 'one-man' or family

corporations have been disallowed or subordinated where the courts have been satisfied that allowance of the claims would not be fair or equitable to other creditors. And that result \* \* \* is reached where the claim asserted is void or voidable because the vote of the interested director or stockholder helped bring it into being or where the history of the corporation shows dominancy and exploitation on the part of the claimant. It is also reached where on the facts the bankrupt has been used merely as a corporate pocket of the dominant stockholder, who, with disregard of the substance or form of corporate management, has treated its affairs as his own. And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in the foregoing types of situations but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan." [footnotes omitted.]

Or, as later and more succinctly explained in *Heiser v. Woodruff*, 327 U.S. 726, 732-3 (1945):

"In appropriate cases, acting upon equitable principles, it [i.e., a bankruptcy court] may also subordinate the claim of one creditor to those of others in order to prevent the consummation of a course of conduct by the claimant which, as to them, would be fraudulent or otherwise inequitable." [bracketed matter added.]

The opinion below cites no cases decided after *Oppenheimer v. Harriman National Bank & Trust Co.*, *supra*, 301 U.S. 206 (1937), and we have found none, which sanctions



the subordination of a claim solely by reason of the status of the claimant as stockholder, director, officer, parent or the like, in relation to the debtor. Rather, this Court and lower courts invariably have insisted that the drastic remedy of equitable subordination be restricted to instances of clearly established misfeasance on the part of the subordinated claimant. *Comstock v. Institutional Investors*, 335 U.S. 211, 229 (1947) [objection to a claim for money advanced by parent to subsidiary overruled in view of parent's good faith and regard for its fiduciary position]; *In re Branding Iron Steak House*, 536 F. 2d 299, 302 (9th Cir. 1976) [subordination of claim for money loaned by officer, director and shareholder reversed in absence of showing of inequitable conduct]; *In the Matter of Mobile Steel Co.*, 563 F. 2d 692, 698-702 (5th Cir. 1977) [subordination of claims of organizers, officers and directors, based on debtor's notes and debentures, reversed for lack of evidence of inequitable conduct]; *Barlow v. Budge*, 172 F. 2d 440, 444 (8th Cir.), *cert. den.* 317 U.S. 647 (1942) [claim for money loaned by director, officer and stockholder accorded parity treatment because transaction "was open, honest and free from unfairness or fault"]; *Spach v. Bryant*, 309 F. 2d 886, 888-9 (5th Cir. 1962) [subordination of claims for money loaned by sole officers and directors refused in absence of showing of fraud or bad faith]; *Schwartz v. Mills*, 192 F. 2d 727, 729 (2d Cir. 1951) [vote for trustee cast by affiliated claimant allowed to stand in absence of evidence of fraud or mismanagement required for subordination]; *Kenneally v. Standard Electronics Corp.*, 364 F. 2d 642, 648-9 (8th Cir. 1966) [subordination of secured claim by affiliated corporation overruled in absence of showing of inequitable conduct].

As held in *In re Branding Iron Steak House*, *supra*, 536 F. 2d at 302:

"Before the legitimate claim of . . . [a] shareholder of a bankrupt corporation may be subordinated to the claims of other creditors, not only must that person have the ability and intent to control the corporation, but he must in fact exercise that control to the detriment of other creditors . . .".

Most recently, *Mobile Steel*, *supra*, after extensive review of the precedents, thus stated the prerequisites for application of the doctrine of equitable subordination, 563 F. 2d at 700:

"(i) the claimant must have engaged in some type of inequitable conduct.

(ii) the misconduct must have resulted in injury to the creditors of the bankrupt and conferred an unfair advantage on the claimant.

(iii) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act." [citations omitted.]

The present petitioners, rank and file purchasers of the debtor's stock, are innocent of any misconduct. The Second Circuit's disposition of this case, therefore, is squarely at odds with settled law on the scope and application of equitable subordination in bankruptcy. This Court should resolve the conflict.

### 3. The decisions below are impermissible judicial legislation.

Both the District Judge and the Court of Appeals concluded that the claims of so-called conventional creditors should be preferred over the claims of defrauded security purchasers because, while both the conventional creditors and the investors assume the risk of insolvency, only the

investors, because they seek greater profits, should have to bear the risk of illegal issuance and later trading of debtors' securities (29a, 16a-17a). The Court of Appeals went on to find that the policy of Chapter X, to provide a fair and equitable distribution, outweighs the policy of the federal securities laws to encourage full and fair corporate disclosure (19a).

Petitioners submit that these findings, assuming *arguendo* the existence of judicial power to implement them, are "beyond the science of the chancery" (*Meinhard v. Salmon*, 249 N.Y. 458, 465, 164 N.E. 545, 547 (1928)).<sup>5</sup>

Concededly, investors take greater risks than conventional creditors. Like conventional creditors, however, investors do not bargain to be defrauded. It is surely far from apparent that the investors should be relegated to inferior and, in most instances, non-participatory status because, lacking material information as to the fraudulence of the enterprise, they expected greater returns. We also submit that it is singularly inappropriate for a conflict between objectives of the federal securities and insolvency laws, assuming that there be one, to be resolved by judicial modification of the Bankruptcy Act.

<sup>5</sup> Another "equity" supposedly favoring conventional creditors over defrauded purchasers of debtors' securities, according to the opinion below (16a-17a), is the "cushion" of stockholders' capital contributions on which conventional creditors are presumed to rely. In the case at bar, however, \$37 million of the \$46 million of conventional claims is represented by bank loans made to the debtor *before* the debtor's preferred stock was sold to the public, when the debtor's equity capital was a mere \$8.5 million. At the very least, under the thesis of *Slaine and Kripke*, fn. 4, *supra*, 48 N.Y.U. L. Rev. at 289, an article heavily relied on in the opinion below (17a), the preferred stockholders among the petitioners-claimants (*Lonetown Company, Goldberg, Mrs. Dixon*) should be ranked with the bank-claimants.

## CONCLUSION

The petition for a writ of certiorari should be granted and the judgment below should be reversed.

Dated: November 13, 1978.

Respectfully submitted,

ROBERT B. BLOCK

*Attorney for Petitioners*

295 Madison Avenue

New York, New York 10017

(212) 532-4800

POMERANTZ LEVY HAUDEK & BLOCK

MILBERG WEISS BERSHAD & SPECTHRIE

BADER & BADER

of New York City,

*Of Counsel*

## **APPENDICES**

**APPENDIX A**

**Opinion of the Court of Appeals**

**UNITED STATES COURT OF APPEALS**

**FOR THE SECOND CIRCUIT**

Nos. 598, 896—September Term, 1977.

(Argued March 20, 1978                      Decided June 19, 1978.)

Docket Nos. 77-5019, 77-5022

In the Matter of  
STIRLING HOMEX CORPORATION,

*Debtor.*

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY, HARRY E. JONES, ALECK GOLDBERG, as Custodian for MARK GOLDBERG, and MRS. D. WINDSOR DIXON,

*Appellants,*

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN FIRST BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MANHATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF CHICAGO; MARINE MIDLAND BANK; THE TRAVELERS INDEMNITY COMPANY; and THE SECURITIES AND EXCHANGE COMMISSION,

*Appellees.*

Before:

KAUFMAN, *Chief Judge,*  
MULLIGAN and MESKILL, *Circuit Judges.*

Appeal from an order entered in the United States District Court for the Western District of New York, Harold



*Appendix A—Opinion of the Court of Appeals*

P. Burke, *Judge*, subordinating claims made by allegedly defrauded stockholders to claims made by ordinary unsecured creditors for purposes of formulating a reorganization plan under Chapter X of the Bankruptcy Act, 11 U.S.C. § 501 *et seq.*

Affirmed.

---

ROBERT B. BLOCK, New York, New York (Pomerantz Levy Haudek & Block, New York, New York, of counsel), *for Appellants Gregory Jezarian, Geraldine Jezarian and Lonetown Company.*

WALTON BADER, New York, New York (Bader & Bader, New York, New York, of counsel), *for Appellant Mrs. D. Windsor Dixon.*

MILBERG WEISS BERSHAD & SPECHTRIE, New York, New York, of counsel, *for Appellants Harry E. Jones and Aleck Goldberg, as Custodian for Mark Goldberg.*

IRVING H. PICARD, Assistant General Counsel, Securities and Exchange Commission, Washington, D.C. (David Ferber, Solicitor to the Commission, Securities and Exchange Commission, Washington, D.C., Marvin E. Jacob, Associate Administrator, Securities and Exchange Commission, New York Regional Office, New York, New York, of counsel), *for Appellee Securities and Exchange Commission.*

*Appendix A—Opinion of the Court of Appeals*

FRANK G. RAICHLE, Rochester, New York (Byron Johnson, Johnson, Reif and Mulligan, P.C., Rochester, New York, of counsel), *for Trustee-Appellee Frank G. Raichle.*

HENRY L. GOODMAN, New York, New York (Zalkin, Rodin & Goodman, Richard S. Toder, Andrew D. Gottfried, New York, New York, Sherman I. Goldberg, Chicago, Illinois, of counsel), *for Appellees, Chemical Bank and The First National Bank of Chicago.*

ALEXANDER C. CORDES, Buffalo, New York (Phillips, Lytle, Hitchcock, Blaine & Huber, Buffalo, New York, of counsel), *for Appellee Marine Midland Bank.*

NIXON, HARGRAVE, DEVANS & DOYLE, Rochester, New York, of counsel, *for Appellee Lincoln First Bank of Rochester.*

MILBANK, TWEED, HADLEY & MCCLOY, John J. Jerome, Barry G. Radick, Michael J. Levin, Patrick E. Mears, New York, New York, of counsel, *for Appellee The Chase Manhattan Bank, N.A.*

BROWN, KELLY, TURNER, HASSETT & LEACH (Frederick D. Turner, Buffalo, New York, of counsel), *for Appellee The Travelers Indemnity Company.*

---

MESKILL, *Circuit Judge:*

This appeal raises questions concerning the proper status of allegedly defrauded investors in reorganization pro-

*Appendix A—Opinion of the Court of Appeals*

ceedings under Chapter X of the Bankruptcy Act. The principal issue is whether claims filed by allegedly defrauded stockholders of a debtor corporation should be subordinated to claims filed by that corporation's ordinary unsecured creditors for purposes of formulating a reorganization plan. Judge Harold P. Burke of the United States District Court for the Western District of New York held that they should be, and we affirm.

The debtor in this case is Stirling Homex Corporation ("Homex").<sup>1</sup> As recently explained by this Court, "Homex manufactured and assembled prefabricated multi-family modular housing. Its operations consisted of mass-producing individual apartment units, or 'modules,' using assembly-line production techniques, shipping them to a construction site and installing them in a previously-constructed concrete and steel frame so as to form multi-unit apartment buildings." *United States v. Stirling*, 571 F.2d 708, 712 (2d Cir. 1978), *petition for cert. filed*, 46 U.S.L.W. 3723 (U.S. May 1, 1978). The nature of Homex's actual operations, however, did not reflect the basically sound and straightforward character of the corporation's underlying concept. Instead, its operations included "land transactions that were not what they were claimed to be, labor

<sup>1</sup> Homex was incorporated on July 22, 1968, under the laws of the State of Delaware; its offices and manufacturing plant were located in New York. Shortly after incorporation, Homex made a private offering of 1.6 million shares at \$1 each. On February 19, 1970, 1,175,000 shares of Homex common stock were sold publicly for \$16.50 per share, out of which the corporation realized approximately \$6.1 million. On July 29, 1971, 500,000 shares of Homex cumulative convertible preferred stock were sold publicly at \$40 per share, and the corporation realized approximately \$19 million. The corporation acquired additional funds by borrowing approximately \$38 million from a consortium of nine banks, some of which are appellees on this appeal.

*Appendix A—Opinion of the Court of Appeals*

relations that were not only inappropriately 'cozy' but undisclosed, contracts for module sales based on guile and trickery rather than agreement, and deceptive bookkeeping practices . . . ." 571 F.2d at 713. Key officials of the corporation "engaged collectively in a calculated and multifaceted plan to give the investing public the false impression that Homex was in a sound and steadily improving financial position and at the same time withhold adverse information that was material to an accurate appraisal of the company's prospects." 571 F.2d at 713-14.<sup>2</sup>

On July 12, 1972, after Homex had been in business for approximately four years, reorganization proceedings were voluntarily initiated in the Western District of New York under Chapter X of the Bankruptcy Act, 11 U.S.C. § 501 *et seq.*<sup>3</sup> Nearly five years later, in July of 1977, Judge Burke determined that the fair market value of Homex's assets was \$16,986,376 and that Homex's debts amounted to \$45,961,000.<sup>4</sup> Accordingly, he found Homex

<sup>2</sup> The Securities and Exchange Commission filed a civil injunctive action against Homex and its officers in the United States District Court for the District of Columbia on July 2, 1975, alleging that they had violated federal securities laws by issuing false and misleading financial statements. The defendants neither admitted nor denied the Commission's allegations, but instead consented to the entry of permanent injunctions against future violations. Criminal indictments were returned against five key Homex officials in 1976 in the Southern District of New York, charging them with securities fraud, mail fraud and conspiracy. After a six-week jury trial, each defendant was convicted of each charge. These convictions were affirmed by this Court. *United States v. Stirling*, 571 F.2d 708 (2d Cir. 1978), *petition for cert. filed*, 46 U.S.L.W. 3723 (U.S. May 1, 1978).

<sup>3</sup> Original jurisdiction over proceedings under Chapter X of the Bankruptcy Act is vested in the district courts of the United States as courts of bankruptcy. See 11 U.S.C. §§ 1(10), 11, 502.

<sup>4</sup> Mr. Frank Raichle, the Reorganization Trustee, originally intended to formulate a plan of reorganization under which Homex

*Appendix A—Opinion of the Court of Appeals*

insolvent and declared that Homex stockholders had no equity in the corporation and could neither vote on a plan or reorganization nor share in the distribution of proceeds resulting from the liquidation of Homex's assets. Judge Burke then ordered the Trustee to prepare and submit a plan for such a distribution.

That same month, at the request of the Trustee and with the consent of the stockholders, Judge Burke filed

---

would continue operations. Borrowing proved impossible, however, as did merger with or acquisition by a financially sound company. He thus began the Herculean task of liquidating Homex's assets. See 11 U.S.C. § 616(10); *Bankers Life & Cas. Co. v. Kirtley*, 338 F.2d 1006, 1009-10 (8th Cir. 1964); 6A Collier on Bankruptcy ¶ 10.19. Of the over 18,000 modules manufactured by Homex before the petition for reorganization was filed, more than half were unsold; by March 31, 1977, all but a few had been sold under approximately 382 separate contracts. Mr. Raichle also sold land, raw materials, machinery, equipment and other assets and secured substantial federal and state tax refunds. As of May 31, 1977, Homex's unliquidated assets were estimated to be worth \$3,749,634; cash and certificates of deposit amounted to \$6,236,742. Finally, Mr. Raichle paid \$7 million to the consortium of banks as an early and partial payment of the amount they will eventually receive under the reorganization plan. In exchange for this advance payment, the banks agreed to waive whatever security interests they had in Homex's assets—security interests that Mr. Raichle disputed—and to withdraw objections to the consolidation of the estates of Homex and its subsidiaries. Under this settlement, effected by court order, the banks assumed their present status as unsecured creditors.

The debt figure of \$45,961,000 represents the aggregate of claims against the Homex estate to which Mr. Raichle has not objected. It includes the approximately \$38 million owed to the bank consortium, less the \$7 million which has already been paid, but it excludes substantially all stockholder claims based on alleged violations of the federal securities laws. In addition to the banks' claims, there are a variety of secured and unsecured claims, claims by former employees for wages and expenses, and claims advanced by federal, state and local taxing authorities.

As of May 31, 1977, the estimated percentage distribution on the claims ranged between 30.46 percent and 34.81 percent—absent any consideration for the stockholders' fraud claims.

*Appendix A—Opinion of the Court of Appeals*

a written decision in which he held that the claims of allegedly defrauded stockholders, some of whom had begun proceedings against Homex and its officers for violations of federal securities laws,<sup>5</sup> were subordinate to those of

---

<sup>5</sup> On April 24, 1972, a class action complaint against Homex, its officers, and its auditors was filed by Homex stockholders in the United States District Court for the Southern District of New York alleging violations of federal securities laws and seeking damages. This complaint was eventually consolidated with other similar actions. The consolidated complaints alleged violations during the period of October 7, 1970, to July 10, 1972. See *In Re Stirling Homex Securities Litigation*, 388 F.Supp. 567 (MDL 1975). Because of a stay entered by Judge Burke prohibiting lawsuits against Homex, the consolidated complaint omitted the corporation as a defendant. See Bankruptcy Rule 10-601(a). On this appeal, the appellants note that "[t]he loss to shareholders, taking account of intermediate market fluctuations in excess of the offering prices, while difficult to estimate, could be as much as \$100,000,000." Appellant's Brief at 5.

Mr. Raichle receive seven claims filed by stockholders containing allegations that Homex made false and misleading statements upon which they relied when purchasing Homex stock. The total amount of these claims was over \$30 million. On July 24, 1975, however, Judge Burke disallowed so much of these claims as was made on behalf of a "class" of claimants—virtually all of the claims. Judge Burke explained that there is no provision in the Bankruptcy Act for the filing of claims in a reorganization proceeding on behalf of a class, a ruling not contested on this appeal, and that the individual members of the purported class had failed to file claims within the period of time defined by a previously-issued order barring claims not made before February 19, 1973. What remained were six claims by allegedly defrauded stockholders totaling \$21,869. Two of those claims, totaling \$6,563, were filed by certain appellants in this appeal; none was filed by the remaining appellants. There is a dispute on this appeal as to whether the claims of the individual stockholders should be barred. The order read in part as follows: "All proofs of claim of creditors against the debtors or their property, of whatever character, either in tort or in contract, fixed or contingent, liquidated or unliquidated, other than those founded on . . . shares of stock, shall be filed with the Trustee of the debtors . . . on or before February 19, 1973." In view of our disposition of the central issue on this appeal, we need not comment on the bar order.



*Appendix A—Opinion of the Court of Appeals*

Homex's general unsecured creditors. Relying on § 197 of the Bankruptcy Act, 11 U.S.C. § 597, and Bankruptcy Rule 10-302(a), Judge Burke ordered that claims by "those creditors whose claims are grounded on fraud or securities law violations committed upon them as stockholders" be subordinated. In so doing, he made the following observations:

If the claims of alleged defrauded stockholders are not subordinated to the claims of conventional general unsecured creditors, a wholly new element will have been created in the financial structure of business. No longer will creditors, whether banks, suppliers, or subcontractors, be free as they now are to extend credit to the ordinary course of business on their presumed right to be accorded priority over the claims of investors and speculators in securities, without first obtaining a secured basis which will guarantee them a priority status in the event their customer defaults. Such a fundamental change in the financial structure of the business community is unwarranted in the absence of legislation designed to overturn the long established rule of absolute priority.

. . . I find that [it] is fair and equitable that the class of conventional general creditors take precedence over the class of alleged defrauded stockholder claims.

Defrauded stockholder claimants in the purchase of stock are presumed to have been bargaining for equity type profits and assumed equity type risks. Conventional creditors are presumed to have dealt with the corporation with the reasonable expectation that they would have a senior position against its assets, to that of alleged stockholder claims based on fraud.

*Appendix A—Opinion of the Court of Appeals*

They may be presumed to have bargained for debt type profits and certainty of payments.

For the reasons that follow, we affirm Judge Burke's order.<sup>6</sup>

DISCUSSION

One of the more significant responsibilities assigned to the bankruptcy court in a Chapter X proceeding is to supervise the formulation of a plan of reorganization that is not only "feasible" but also "fair and equitable." See 11 U.S.C. §§ 574, 621(2). Central to the accomplishment of this task is the proper classification and ordering of the debtor corporation's creditors and stockholders: "For the purposes of the plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and

<sup>6</sup> Our appellate jurisdiction is based on § 24 of the Bankruptcy Act, 11 U.S.C. § 47, which provides as follows:

The United States courts of appeals . . . are invested with appellate jurisdiction from the several courts of bankruptcy in their respective jurisdictions in proceedings in bankruptcy, either interlocutory or final, and in controversies arising in proceedings in bankruptcy, to review, affirm, revise, or reverse, both in matters of law and in matters of fact . . .

Except where inconsistent with Chapter X, the provisions of § 24 are applicable to appeals generated by reorganization proceedings. See 11 U.S.C. § 521; *In Re Wingreen Co.*, 412 F.2d 1048, 1050-51 (5th Cir. 1969); 2 Collier on Bankruptcy ¶ 24.45; 6 Collier on Bankruptcy ¶ 3.40. "Under the present Act, the general rule is that an appeal from an order or decree entered in a 'proceeding in bankruptcy', either interlocutory or final, may be taken as of right, without any necessity for the securing of an allowance from the court of appeals." 2 Collier on Bankruptcy ¶ 24.11[3] (footnote omitted). Judge Burke's order subordinating the stockholders' claims to the more conventional unsecured creditors' claims was issued during a "proceeding in bankruptcy." See *id.* at ¶¶ 24.12, 24.19.



Appendix A—Opinion of the Court of Appeals

stock.” 11 U.S.C. § 597; see Bankruptcy Rule 10-302(a).<sup>7</sup>

As explained by the Tenth Circuit in 1945, this classification of claims “is simply a method of recognizing difference in rights of creditors which calls for difference in treatment.” *Scherk v. Newton*, 152 F.2d 747, 750. Once classified, the various classes must not only be ranked “according to the nature of their respective claims,” but also according to the “absolute priority” rule. Under this rule, no class may receive anything of value until senior classes have received full compensation for the value of their claims. For example, creditors holding security interests in the assets of the debtor must be ranked ahead of all other creditors with respect to those assets. After the satisfaction of the secured creditors, general unsecured creditors are entitled to satisfaction before assets may be allocated to creditors whose interests have been subordinated, whether by express agreement or otherwise. Finally, after all creditors have been paid, provision may be made for stockholders. When the debtor is insolvent, the stockholders, as such, receive nothing. See *Northern Pacific Ry. v. Boyd*, 228 U.S. 482 (1913); *Case v. Los Angeles Lumber Co.*, 308 U.S. 106 (1939); *Consolidated Rock Co. v. DuBois*, 312 U.S. 510 (1941); *Protective Committee v. Anderson*, 390 U.S. 414 (1968). See also *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 435-38 (1972) (Douglas, J., dissenting); see generally 6A Collier on Bankruptcy ¶ 11.06. The question on this appeal, of course, is not whether Homex stockholders are entitled,

<sup>7</sup> The rule reads as follows:

For the purposes of the plan and its acceptance, the court may fix, after hearing on such notice as it may direct, the division of creditors and stockholders into classes according to the nature of their respective claims and stock.

Appendix A—Opinion of the Court of Appeals

as stockholders, to a portion of the proceeds that will result from the liquidation of Homex's assets. Because of the absolute priority rule, they are not. Rather, the question is whether persons who were allegedly induced by fraud to purchase Homex stock should be allowed, in a reorganization proceeding, to assert claims in such a way as to achieve parity with ordinary unsecured tort and contract claimants.<sup>8</sup>

<sup>8</sup> The Supreme Court has, on two occasions, left this question unanswered. See *Protective Committee v. Anderson*, 390 U.S. 414, 423 & n.8, 453 (1968); *Tcherepnin v. Knight*, 389 U.S. 332, 346 (1967). We do not consider the 1939 decision of *Oppenheimer v. Harriman National Bank & Trust Co.*, 301 U.S. 206 (1937), upon which the stockholders in this dispute rely, to be of controlling significance in Chapter X reorganization efforts. Mr. Oppenheimer bought stock in the Harriman bank in 1930. The bank closed in 1933, and, while it was being liquidated by the Comptroller of the Currency, Oppenheimer sued for rescission based on a claim of fraud and secured a money judgment for the amount he paid for his shares. The Second Circuit ordered that the judgment be paid only “after payment of all who were creditors when the bank became insolvent.” 85 F.2d 585. The Supreme Court reversed, holding that Oppenheimer’s “judgment is entitled to rank on a parity with other unsecured creditor’s claims.” 301 U.S. at 215 (footnote omitted). Significantly, the *Oppenheimer* decision, based on facts that occurred prior to federal securities legislation, was made not pursuant to the Bankruptcy Act but under an entirely different statutory scheme—the National Bank Act, 12 U.S.C. § 1 *et seq.*—under which distribution is to be “ratable” rather than “fair and equitable.” See 12 U.S.C. § 194.

There are, of course, a number of cases in which Trustees in Chapter X proceedings, faced with colorable claims made by allegedly defrauded stockholders, have decided to settle or compromise rather than litigate the position of such claimants. See *In Re Equity Funding Corp. of America*, 416 F.Supp. 132, 151 (D.C. Cal.), *aff’d*, 519 F.2d 1274 (9th Cir. 1975); Huff, The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5, 50 Am. Bankr. L.J. 197, 215 (1976). The stockholders on this appeal admit, however, that there are no rulings that mandate parity participation in a reorganization plan by allegedly defrauded stockholders over a trustee’s objection.

*Appendix A—Opinion of the Court of Appeals*

Section 106(4) of the Bankruptcy Act, 11 U.S.C. § 506(4), defines “creditor” as “the holder of any claim.” Section 106(1) of the Act, 11 U.S.C. § 506(1), defines “claims” to “include all claims of whatever character against a debtor or its property, except stock, whether or not such claims are provable under section 103 of this title and whether secured or unsecured, liquidated or unliquidated, fixed or contingent.” As noted in *Collier*:

The word “claims” as defined in § 106(1) is sweeping in scope. Within its purview is any character of a claim against the debtor or its property, whether or not such claim is provable under § 63 of the Act, and whether secured or unsecured, liquidated or unliquidated, fixed or contingent. This is, of course, a more inclusive definition than that applicable in ordinary bankruptcy, and it should be given a broad construction with respect to claims and creditors in order to dispose of all liabilities of the debtor in reorganization.

6 *Collier on Bankruptcy* ¶ 2.05, at 306 (footnotes omitted). Thus, inasmuch as the stockholders on this appeal are basing their claims not on their ownership of stock certificates but on the alleged fraud that was perpetrated upon them by the corporation when they purchased those certificates, they are, at least arguably, “creditors” making “claims” for purposes of a Chapter X reorganization. With this Judge Burke seems to have agreed, for he referred to both “conventional general creditors” and “those creditors whose claims are grounded on fraud or securities law violations committed upon them as stockholders.” See also *In Re Four Seasons Nursing Centers of America, Inc.*, 472 F.2d 747, 749-50 (10th Cir. 1973). On this appeal we will assume, as Judge Burke did, without decid-

*Appendix A—Opinion of the Court of Appeals*

ing that defrauded stockholders are creditors within the meaning of the Bankruptcy Act, and we will consider the more narrow question whether it was inequitable for Judge Burke to subordinate the claims by the stockholders to those made by ordinary general creditors. We conclude that it was not.

In *Pepper v. Litton*, 308 U.S. 295 (1939), the Supreme Court agreed to review a lower court decision “because of an apparent restriction imposed by that decision on the power of the bankruptcy court to disallow or to subordinate . . . claims in the exercise of its broad equitable powers.” 308 U.S. at 296. In the course of its opinion, the Court reaffirmed that “‘courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity.’” 308 U.S. at 304, quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934). Accordingly, the bankruptcy court is to apply “the principles and rules of equity jurisprudence.” 308 U.S. at 304. See also 11 U.S.C. § 11(a). The Court also said that among the powers available to the bankruptcy court to effect this mandate is the power of “subordination in light of equitable considerations.” 308 U.S. at 305.

The mere fact that an officer, director, or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it *pari passu* treatment with the claims of other creditors. Its disallowance or subordination may be necessitated by certain cardinal principles of equity jurisprudence.

308 U.S. at 306. The Court also noted:

In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances

*Appendix A—Opinion of the Court of Appeals*

surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder. That is clearly the power and duty of the bankruptcy courts under the reorganization sections.

308 U.S. at 307-08 (footnote omitted). *See also In Re Four Seasons Nursing Centers of America, Inc., supra*, 472 F.2d at 749 ("The reorganization court as a court of equity has broad powers in the matter of classifying creditors and shareholders, and it necessarily has full power to subordinate interests or classes of interests where the equities demand."); *In Re Sixty-Seven Wall Street Restaurant Corp.*, 23 F.Supp. 672, 673, 674 (S.D.N.Y. 1938).

*Collier* has made similar observations regarding subordination which are directly relevant to this appeal:

Creditors holding claims against the debtor's estate of a kind not secured within the meaning of the Act are classified as unsecured or general creditors. The fact that the claims may take various forms—as, for example, notes, accounts, written contracts, torts or the like—will not ordinarily compel separate classification since an unsecured indebtedness or liability is the common denominator of all.

Within the total group of unsecured creditors, however, there may be certain ones whose claims are of such a nature as to give them some right of priority or preference over other claimants. These creditors, then, must be separately classified and accorded the priority to which they are entitled.

*Appendix A—Opinion of the Court of Appeals*

6 *Collier on Bankruptcy* ¶ 9.13, at 1620-21 (footnotes omitted).

Subordination is a means of regulating distribution results in reorganization by adjusting the respective order of claimants and stockholders to the equitable levels of the comparative claim positions in the proceeding. Its fundamental aim is to undo or offset any inequity in the position of a creditor or stockholder which will produce injustice or unfairness to the other creditors or stockholders in terms of reorganization results.

6 *Collier on Bankruptcy* ¶ 9.15, at 1644-45. Given the broad equitable powers with which the bankruptcy court is endowed, and given the expectations that conventional creditors and investors have when they extend credit or invest, we cannot say that Judge Burke acted improperly.

Where the debtor corporation is insolvent and is about to undergo complete liquidation, the equities favor the conventional general creditors rather than the allegedly defrauded stockholders. In such circumstances, "[t]he real party against which [the stockholders] are seeking relief is the body of general creditors of their corporation. Whatever relief may be granted to them in this case will reduce the percentage which the general creditors will ultimately realize upon their claims." *Scott v. Abbott*, 160 F. 573, 581 (8th Cir.), *cert. denied*, 212 U.S. 571 (1908). We will not allow stockholders whose claims are based solely on the alleged fraud that took place in the issuance of stock to deplete further the already meager pool of assets presently available to the general creditors. *See also Matter of Cartridge Television, Inc.*, 535 F.2d 1388 (2d Cir. 1976) (straight bankruptcy); *In the Matter of Crimmins*, 406



*Appendix A—Opinion of the Court of Appeals*

F.Supp. 282 (S.D.N.Y. 1975) (straight bankruptcy). In so deciding, we heed the observation made many years ago by the Eighth Circuit: "When a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder, on one pretense or another, and to assume the role of a creditor, is very strong, and all attempts of that kind should be viewed with suspicion." *Newton National Bank v. Newbegin*, 74 F. 135, 140 (8th Cir. 1896). We also note that, "[a]s a general rule equity prefers the claims of innocent general creditors over the claims of shareholders or subordinated creditors deceived by officers of the corporation." *F.D.I.C. v. American Bank Trust Shares, Inc.*, 412 F.Supp. 302, 308 (D.S.C. 1976), *vacated on other grounds*, 558 F.2d 711 (4th Cir. 1977). See also *Scott v. DeWeese*, 181 U.S. 202, 213 (1901); *Sanger v. Upton*, 91 U.S. [1 Otto] 56, 60 (1875); *Upton v. Tribilcock*, 91 U.S. [1 Otto] 45, 47 (1875); *Carter v. Bogden*, 13 F.2d 90, 93-94 (8th Cir. 1926); *Scott v. Abbott*, *supra*, 160 F. at 582.

This general rule is altogether fitting. When persons or institutions lend money to a corporation, or otherwise become its creditors, they do so in reliance upon the protection and security provided by the money invested by the corporation's stockholders—the so-called "equity cushion." In effect, when stock is purchased, the purchaser of that stock invites other segments of the business world to do business with the issuer. "This [reliance] is not only theoretically true, but common experience teaches that it is practically true also." *Scott v. Abbott*, *supra*, 160 F. at 582. The general creditors also rely on the absolute priority rule when deciding to extend credit: "The reliance need not be manifest—the stockholders are presumed to have knowledge of priority rights. . . . Credit is given to corporations with little or no knowledge of names of stock-

*Appendix A—Opinion of the Court of Appeals*

holders, but with confidence that, whoever they are, their rights in and to corporate property are subordinate to the rights of creditors." Huff, *The Defrauded Investor in Chapter X Reorganization: Absolute Priority v. Rule 10b-5*, 50 Am. Bankr. L.J. 197, 205 (1976).

As explained in a leading article on this question, Slain & Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Security Holders and the Issuer's Creditors*, 48 N.Y.U.L. Rev. 261 (1973), there are two entirely distinct types of risks taken by creditors and investors when they decide to do business with a corporation: the risk of insolvency of the debtor and the risk of unlawful issuance of securities. *Id.* at 286. It is appropriate that both the general creditors and the investors assume the risk of insolvency. As between the creditors and the investors, however, only the investors should be forced to bear the risk of illegality in the issuance of stock.

In theory, the general creditor asserts a fixed dollar claim and leaves the variable profit to the stockholder; the stockholder takes the profit and provides a cushion of security for payment of the lender's fixed dollar claim. The absolute priority rule reflects the different degree to which each party assumes a risk of enterprise insolvency; no obvious reason exists for re-allocating that risk.

*Id.* at 286-87. Slain and Kripke also note that "[i]t is difficult to conceive of any reason for shifting even a small portion of the risk of illegality [in the stock issuance] from the stockholder, since it is to the stockholder, and not the creditor, that the stock is offered." *Id.* at 288. With this we quite agree.



*Appendix A—Opinion of the Court of Appeals*

Finally, we note that the United States Congress is in the process of considering this very question as part of its review of the entire law of bankruptcy. Section 510 of H.R. 8200, 95th Cong., 1st Sess. (1978), which was passed by the House of Representatives on February 1, 1978, 124 Cong. Rec. at H. 457 (1978), provides as follows:

*Subordination of Claims*

(a) After notice and a hearing, the court shall—

...

(2) subordinate for purposes of distribution any claim for rescission of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security to all claims and interests that are senior or equal to the claim or interest represented by such security.

(b) Notwithstanding subsection (a) of this section, after notice and hearing, the court may, on equitable grounds—

(1) subordinate for purposes of distribution all or part of an allowed claim or interest to all or any part of another allowed claim or interest. . . .

Section 510 of the parallel Senate bill, S. 2266, contains virtually identical language. S. 2266, 95th Cong., 1st Sess. (1977). The report on H.R. 8200 of the House Committee on the Judiciary, H.R. Rep. No. 95-595, 95th Cong., 1st Sess. (1977), adopts substantially the point of view of the Slain & Kripke article. The Report explains that, under subsection (a), "[i]f the security is an equity security, the damages or rescission claim is subordinated to

all creditors and treated the same as the equity security itself." *Id.* at 359. The Report explains that subsection (b) "is intended to codify case law, such as *Pepper v. Litton* . . . and *Taylor v. Standard Gas and Electric Co.* . . . and is not intended to limit the court's power in any way. The bankruptcy court will remain a court of equity . . . . The court's power is broader than the general doctrine of equitable subordination, and encompasses subordination on any equitable grounds." *Id.* In general, the Report notes that, "[t]he general creditors have not had the potential benefit of the proceeds of the enterprise deriving from ownership of securities and it is inequitable to permit shareholders that have had this potential benefit to shift the loss to general creditors." *Id.* at 195. Although it is plain that we are not bound by this legislative activity, we find the reasoning behind it, supported by the Commission on the Bankruptcy Laws of the United States and the National Conference of Bankruptcy Judges, quite persuasive.

To decide in a way other than we decide today would not only violate our sense of simple fairness, it would unduly promote the policy of the federal securities laws to encourage full and fair corporate disclosure at the expense of the policy of Chapter X of the Bankruptcy Act to provide a "fair and equitable" distribution among the interested parties. This we decline to do.

The decision of the district court is affirmed.

## APPENDIX B

## Judgment of the Court of Appeals

UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT

—o—

At a Stated Term of the United States Court of Appeals,  
in and for the Second Circuit, held at the United States  
Courthouse in the City of New York, on the nineteenth day  
of June one thousand nine hundred and seventy-eight.

Present:

HON. IRVING R. KAUFMAN  
*Chief Judge*

HON. WILLIAM H. MULLIGAN  
HON. THOMAS J. MESKILL  
*Circuit Judges.*

77-5019  
77-5022

—•—  
In the Matter of  
STIRLING HOMEX CORPORATION,

*Debtor,*

v.

MRS. D. WINDSOR DIXON, in her own behalf and in behalf  
of all other stockholders of Stirling Homex Corporation  
similarly situated, GREGORY JEZARIAN, GERALDINE JEZARIAN  
AND LONETOWN COMPANY,

*Appellants.*

—•—  
Appeal from the United States District Court for the  
Western District of New York.

*Appendix B—Judgment of the Court of Appeals*

This cause came on to be heard on the transcript of record  
from the United States District Court for the Western  
District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered,  
adjudged, and decreed that the Order of said District Court  
be and it hereby is affirmed in accordance with the opinion  
of this court with costs to be taxed against the appellants.

[SEAL]

A. DANIEL FUSARO,  
*Clerk*

By ARTHUR HELLER  
*Deputy Clerk*

**APPENDIX C****Decision of the Court of Appeals  
Denying Petition for Rehearing**UNITED STATES COURT OF APPEALS  
SECOND CIRCUIT  

---

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the seventeenth day of August, one thousand nine hundred and seventy-eight.

77-5019  

---

In the Matter of  
STIRLING HOMEX CORPORATION,*Debtor,*

v.

MRS. D. WINDSOR DIXON, in her own behalf and in behalf of all other stockholders of Stirling Homex Corporation similarly situated, GREGORY JEZARIAN, GERALDINE JEZARIAN AND LONETOWN COMPANY,

*Appellants.*  

---

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellants, Mrs. D. Windsor Dixon, etc. Gregory Jezarian, et. al., and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

*Appendix C—Decision of the Court of Appeals  
Denying Petition for Rehearing*

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

[SEAL]

/s/ IRVING R. KAUFMAN  
Chief Judge  
IRVING R. KAUFMAN

**APPENDIX D****Opinion of the District Court****UNITED STATES DISTRICT COURT**

WESTERN DISTRICT OF NEW YORK

BK-72-1399

---

In the Matter  
of

STIRLING HOMEX CORPORATION,  
Consolidated Debtor  
(Classification of Claims)

---

IN PROCEEDING FOR REORGANIZATION UNDER CHAPTER X  
OF THE BANKRUPTCY ACT

---

Johnson, Reif & Mullan  
47 South Fitzhugh Street  
Rochester, N.Y. 14614  
Attorneys for Trustee

Brown, Kelly, Turner, Hassett & Leach  
290 Main Street  
Buffalo, N.Y. 14202  
Attorneys for Travelers Indemnity

Pomerantz, Levy, Haudek & Block  
295 Madison Avenue  
New York, N.Y. 10017  
Attorneys for Gregory Jezarian, et al.

Milberg, Weiss, Bershad & Specthrie  
One Pennsylvania Plaza  
New York, N.Y. 10001  
Attorneys for Harry E. Jones, et ano.

*Appendix D—Opinion of the District Court*

Bader & Bader  
270 Madison Avenue  
New York, N.Y. 10016  
Attorneys for Mrs. D. Windsor Dixon

Nixon, Hargrave, Devans & Doyle  
Lincoln First Tower  
Rochester, N.Y. 14603  
Attorneys for Lincoln First Bank of Rochester

Balkin, Rodin & Goodman  
750 Third Avenue  
New York, N.Y. 10017  
Attorneys for Chemical Bank, The Chase Manhattan  
Bank, N.W. and The First National Bank of Chicago

Phillips, Lytle, Hitchcock, Blaine & Huber  
3400 Marine Midland Center  
Buffalo, N.Y. 14203  
Attorneys for Marine Midland Bank

Securities and Exchange Commission  
26 Federal Plaza  
New York, N.Y. 10007

Brown, Wood, Ivey, Mitchell & Petty  
One Liberty Plaza  
New York, N.Y. 10006  
Attorneys for Merrill, Lynch, Pierce, Fenner  
& Smith, Inc.

On the application of the Trustee in reorganization of  
Stirling Homex Corporation, consolidated debtor, this court  
by order dated April 28, 1977 fixed June 13, 1977 at 2:00  
P.M. in the United States Court House, Rochester, New  
York, as the time and place of a hearing for a determination



*Appendix D—Opinion of the District Court*

that the consolidated debtor be adjudicated insolvent and that the stockholders may not vote on any proposed plan of reorganization or participate in any distribution; and for a determination whether the stockholders who have heretofore filed proofs of claim based on fraud or other securities law violations shall be included as general creditors for the purpose of participation in any distribution under any adopted plan of reorganization.

A hearing was held on June 13, 1977 as directed. On the testimony of the Trustee and on the papers and reports filed, the consolidated debtor, Stirling Homex Corporation, has been found to be insolvent. The Trustee has reported that a reorganization of the debtor in the sense of floating out of trusteeship a workable operating company is impossible; that the only fair and equitable plan which can be promulgated would be one of orderly liquidation of the debtor's assets and a distribution of the proceeds among its creditors. The Trustee moves for a judicial determination whether stockholders who have previously filed proofs of claim based on alleged fraud or other securities violations should share on an equal basis with general unsecured creditors in any distribution under any plan to be proposed.

At the hearing Robert B. Block of the firm of Pomerantz, Levy, Haudek & Block, attorneys for plaintiffs in a certified class action, Jezarian et al vs. Caspo et al, pending in the United States District Court for the Southern District of New York, 72 Civ. 1677, appeared for this class which includes thousands of stockholders of the debtor, past and present, arguing that the members of the class should share in any distribution. At the hearing there also appeared I. Walton Bader of the firm Bader & Bader, representing an additional class of preferred present stockholders of the debtor.

*Appendix D—Opinion of the District Court*

With the express consent of all parties present, and at the request of the Trustee, the hearing was broadened to include a determination of the claims of the allegedly defrauded stockholders, past and present, whether they had theretofore filed proofs of claim or not.

Section 197 of the Bankruptcy Act reads in part, "For the purposes of the plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock."

Rule 10-302 of the Rules of Bankruptcy Procedure provides in part as follows: "(a) Classification of Claims: For the purposes of the plan and its acceptance, the court may fix, after hearing on such notice as it may direct, the division of creditors and stockholders into classes according to the nature of their respective claims and stock."

At the hearing, counsel for the certified class estimated that the claims of the members of the class would aggregate approximately One Hundred Million Dollars (TR 26) with an anticipated total of Fifteen Million or Sixteen Million Dollars to be distributed among all unsecured creditors. A determination of whether allegedly defrauded stockholders should share in the distribution on an equal basis with the Forty-six Million Dollars of claims of conventional general unsecured creditors should be determined before the formulation of a plan.

The plan for which the classification of claimants is sought is not a plan of reorganization in the sense of floating out of the Trustee a workable operating company. The consolidated debtor has been adjudicated insolvent. The only fair and equitable plan is one which would provide for orderly liquidation of the debtor's assets and a distribution of the proceeds among its creditors.

*Appendix D—Opinion of the District Court*

The stockholders claims based on fraud or other violations of securities laws, are contingent and unliquidated. The contingent claimants are not now and may never be creditors of the consolidated debtor. A determination of the claims involves serious factual and legal issues. Substantial disputes may well be expected to arise in establishing the claims of any such alleged creditors, the application of limitation of actions and the measure of damages.

If the claims of alleged defrauded stockholders are not subordinated to the claims of conventional general unsecured creditors, a wholly new element will have been created in the financial structure of business. No longer will creditors, whether banks, suppliers, or subcontractors, be free as they now are to extend credit to the ordinary course of business on their presumed right to be accorded priority over the claims of investors and speculators in securities, without first obtaining a secured basis which will guarantee them a priority status in the event their customer defaults. Such a fundamental change in the financial structure of the business community is unwarranted in the absence of legislation designed to overturn the long established rule of absolute priority.

Where, as here, the debtor has been adjudicated insolvent, and the stockholders as such may not participate in distribution, the plan must be one of liquidation and distribution to the creditors. A determination is required as to whether the conventional general creditors and those creditors whose claims are grounded on fraud or securities law violations committed upon them as stockholders, shall share equally in distribution or whether the class of conventional creditors shall take precedence over the class of defrauded stockholder creditors. I find that is is fair and equitable that the class of conventional general creditors take precedence over the class of alleged defrauded stockholder claims.

*Appendix D—Opinion of the District Court*

Defrauded stockholder claimants in the purchase of stock are presumed to have been bargaining for equity type profits and assumed equity type risks. Conventional creditors are presumed to have dealt with the corporation with the reasonable expectation that they would have a senior position against its assets, to that of alleged stockholder claims based on fraud. They may be presumed to have bargained for debt type profits and certainty of payment.

On all the evidence it is hereby

ORDERED that, in the exercise of discretion, the claims of allegedly defrauded stockholders are classified as subordinate to the claims of conventional general creditors.

/s/ HAROLD P. BURKE

---

HAROLD P. BURKE  
United States District Judge

July 27, 1977.

SUPREME COURT, U. S.  
**FILED**

DEC 8 1978

MICHAEL MODAK, JR., CLERK

---

IN THE

# Supreme Court of the United States

---

November Term, 1978

---

No. 78-869

---

In the Matter of  
STIRLING HOMEX CORPORATION,

*Debtor.*

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY, HARRY E. JONES, ALECK GOLDBERG, as Custodian for MARK GOLDBERG, and MRS. D. WINDSOR DIXON,

*Petitioners,*

vs.

FRANK G. RAICHLE, Reorganization Trustee, LINCOLN FIRST BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MANHATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF CHICAGO; MARINE MIDLAND BANK; THE TRAVELERS INDEMNITY COMPANY; and THE SECURITIES AND EXCHANGE COMMISSION,

*Respondents.*

---

ON PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

---

## **BRIEF FOR RESPONDENT FRANK G. RAICHLE, REORGANIZATION TRUSTEE**

---

FRANK G. RAICHLE,  
*Attorney for Respondent*

*Frank G. Raichle, Reorganization  
Trustee*

10 Lafayette Square  
Buffalo, New York 14203  
Tel.: 716-852-7587

JOHNSON, REIF AND MULLAN, P.C.,  
BYRON JOHNSON,  
*Of Counsel*



## TABLE OF CONTENTS

	Page
The Opinion .....	2
Jurisdiction .....	2
Question Presented .....	2
Facts .....	3
Argument .....	4
Conclusion .....	12

## TABLE OF CITATIONS

### CASES

Atlantic Gypsum Co. v. Federal National Bank of Boston, 76 F. 2d 59 (1st Cir. 1935) .....	11
Carter v. Bogden, 13 F. 2d 90 (8th Cir. 1926) .....	5
F.D.I.C. v. American Bank Trust Shares, Inc., 412 F. Supp. 302 (D.S.C. 1976) .....	5
<i>In re</i> Groenleer-Vance Furniture Co., 23 F. Supp. 713 (W.D. Mich., 1938) .....	6
<i>In re</i> Irving Whitehouse Co., 293 Fed. 287 (9th Cir. 1923)	10
Matter of Mobile Steel Co., 563 F. 2d 692 (5th Cir. 1977)	11
Oppenheimer v. Harriman National Bank and Trust Co., 301 U. S. 206 (1937) .....	10, 11
Pepper v. Litton, 308 U.S. 295 (1939) .....	6
Scott v. Abbott, 160 Fed. 573 (8th Cir. 1908), <i>cert.</i> <i>denied</i> , 212 U.S. 571 (1908) .....	5
Scott v. Deweese, 181 U.S. 203 (1901) .....	8

II.

Page

STATUTES

Bankruptcy Act, 11 U.S.C. § 501, <i>et seq.</i> .....	3
§ 197, 11 U.S.C. § 597 .....	4,11
Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 93 Stat. -	
§ 510(b) .....	3,4,8
National Bank Act § 194 .....	10

MISCELLANEOUS

Slain and Kripke, 48 N.Y.U.L. Rev. 261 (1973) .....	9,10
---	------

IN THE

**Supreme Court of the United States**

November Term, 1978

No. 78-869

In the Matter of  
STIRLING HOMEX CORPORATION,

*Debtor.*

GREGORY JEZARIAN, GERALDINE JEZARIAN,  
LONETOWN COMPANY, HARRY E. JONES, ALECK  
GOLDBERG, as Custodian for MARK GOLDBERG, and  
MRS. D. WINDSOR DIXON,

*Petitioners,*

vs.

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN  
FIRST BANK OF ROCHESTER; CHEMICAL BANK;  
THE CHASE MANHATTAN BANK, N.A.; THE FIRST  
NATIONAL BANK OF CHICAGO; MARINE MIDLAND  
BANK; THE TRAVELERS INDEMNITY COMPANY; and  
THE SECURITIES AND EXCHANGE COMMISSION,

*Respondents.*

On Petition for a Writ of Certiorari to the  
United States Court of Appeals for the Second Circuit

**BRIEF FOR RESPONDENT FRANK G. RAICHLE,  
REORGANIZATION TRUSTEE**

**The Opinion**

The opinion of the court below is reported at 579 F. 2d 206 (2d Cir. 1978).

**Jurisdiction**

Petitioners' claim for jurisdiction is based on 28 USC § 1254(1).

**Question Presented**

Did the District Court, sitting as a Court of Bankruptcy, under the facts of this case abuse its discretion in subordinating the claims of allegedly defrauded stockholders to the claims of orthodox and conventional general unsecured creditors?

The District Court's disposition of the matter of subordination in the case at bar reads as follows:

"On all the evidence it is hereby<sup>1</sup>

"ORDERED that, in the *exercise of discretion* the claims of allegedly defrauded stockholders are classified as subordinate to the claims of conventional general creditors." (Appendix D annexed to Petition, 29a.) (Emphasis added)

Accordingly, the resolution of the question presented involves an examination of the facts of this many faceted and complicated bankruptcy proceeding.

<sup>1</sup> The Court's decision was made after a hearing at which much evidence was received and all the parties had an opportunity to be heard.

The Court of Appeals in its opinion stated, "... we will consider the more *narrow* question whether it was *inequitable* for Judge Burke to subordinate the claims by stockholders to those made by general creditors. We conclude that it was not." (Appendix A annexed to Petition, 13a.) (Emphasis added)

Hardly a subject of further review by this busy Court, especially in view of the fact that the Bankruptcy Reform Act of 1978 § 510(b) now directs such a subordination of claims of allegedly defrauded stockholders.

**Facts**

On July 12, 1972 Stirling Homex Corporation which had been in the business of mass producing individual apartment units or "modules" using assembly line production techniques filed a voluntary petition in the Western District of New York under Chapter X of the Bankruptcy Act, 11 U.S.C. § 501, *et seq.* Nearly five years later, in July of 1977 after futile efforts by the reorganization trustee to reorganize the company in the sense of floating out of the trusteeship a viable operating company, it was determined by the District Court that Stirling Homex Corporation was hopelessly insolvent. The District Court made and entered an order finding that Stirling Homex Corporation's assets amounted to \$16,986,376 and that its debts amounted to \$45,961,000 (4a). Accordingly, the District Court found the corporation insolvent and declared that its stockholders had no equity in the corporation and could neither vote on the plan of reorganization nor share in the distribution of the proceeds resulting from the liquidation of its assets. The corporation was a publicly owned company and various of the stockholders claimed to have been defrauded in the purchase of their stock. Certain of the allegedly defrauded stockholders made claims grounded on fraud and



securities law violations. The District Court, on application of the trustee under § 197 of the Bankruptcy Act<sup>2</sup>, 11 U.S.C. 597, subordinated the claims of the allegedly defrauded stockholders to the claims of the orthodox and conventional creditors, including banks, suppliers and employees.

### Argument

In the first place, so far as the granting of a writ of certiorari is concerned, we observe that the issue sought to be raised by the petitioners is not a "live one."<sup>3</sup> The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, subordinates as did the District Court the claims of all defrauded security purchasers; see § 510(b) of the Act. This section of the Bankruptcy Reform Act which is merely a codification of existing law provides as follows:

"Any claim for rescission of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security shall be subordinated for purposes of distribution to all claims and interests that are senior or equal to the claim or interest represented by such security." (Bankruptcy Reform Act of 1978, § 510(b).)

In directing the subordination of the claims of so-called defrauded stockholders, even in the absence of a statute, the District Court was following the general rule of equity as well as equitable considerations peculiar to this case.

<sup>2</sup> Section 197 of the Bankruptcy Act reads as follows:

"For the purposes of the plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock."

<sup>3</sup> Indeed it never was.

"As a general rule equity prefers the claims of innocent general creditors over the claims of shareholders or subordinated creditors deceived by officers of the corporation." *F.D.I.C. vs. American Bank Trust Shares, Inc.*, 412 F. Supp. 302, 308 (D.S.C. 1976).

Language directly in point with the case at bar is that of the court in *Carter v. Bogden*, 13 F. 2d 90 (8th Cir. 1926). The reporter's Note 1 in that case reads as follows:

"Claims of innocent creditors of bankrupt corporation entitled to preference over those of stockholders deceived by its officers."

In the course of its opinion in that case the Court said at 13 F.2d 93-94,

"Anyone, becoming a creditor of a corporation, has a right to rely on the security afforded by the money or assets paid in by the stockholders for its capital stock, and in a proper case equity will prefer the claims of innocent general creditors over claims of stockholders deceived by officers of a corporation (Citing cases.)" (Emphasis added)

This is our point exactly!

In the case of *Scott v. Abbott*, 160 Fed. 573 (8th Cir. 1908), cert. denied, 212 U.S. 571 (1908) the Eighth Circuit developed the history of the general rule that calls for the subordination of the so-called defrauded stockholders' claims to the claims of general unsecured creditors. In the course of its opinion the Court stated at 852,

"In view of the foregoing facts and principles the rights of the innocent creditors are superior to those of the deceived stockholders."

The facts were similar to our case. In another case the Court said:

"Courts have repeatedly frowned upon the attempt of a stockholder after bankruptcy to 'lay aside the garb of a stockholder, on one pretense or another, and to assume the role of a creditor.'" *In re Groenleer-Vance Furniture Co.*, 23 F. Supp. 713, 715 (W.D. Mich., 1938).

In any event, the bankruptcy court has broad equitable powers with respect to the subordination of claims. See, *Pep- per v. Litton*, 308 U.S. 295, 307 (1939), where the court said,

"As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claim in bankruptcy. In the exercise of equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate."

We now pass to a brief discussion of the facts which make the general rule particularly applicable to the case at bar.

The subordination of the so-called defrauded stockholders' claims to the claims of the orthodox and conventional unsecured creditors is justified, indeed called for in this case, by the consideration of the investment expectations of the parties. The equity investors, in this case, were seeking equity profits—high profits, many times the issue price—and assumed equity risks. The orthodox and conventional creditors, such as lenders, suppliers and workers, sought only a normal business profit. They bargained for debt type profits and certainty of payment. Stockholders are often prepared to wait long periods of time for substantial profits, whereas lenders and trade creditors, to say nothing of workers, expect a reasonably prompt payment.<sup>4</sup> Here they have waited six and

<sup>4</sup> The claims of orthodox and conventional unsecured creditors include the claims of hundreds of workers and small suppliers.

one-half years, and if petitioners could prevail, would face the prospect of years of further waiting.

Importantly, too, a subordination prevents straddling tactics such as those employed by these allegedly defrauded stockholders. A security holder seeking to rescind is attempting to avail himself of an alternative that the general creditor does not have. To use a current expression, he has the best of two worlds. If things go well he can elect to be a stockholder. If things go poorly, he seeks to be a creditor. The so-called defrauded stockholders in the case at bar<sup>5</sup> waited over five years after the filing of the bankruptcy petition on July 12, 1972 to threaten to make claims against the bankrupt estate. They waited until it was apparent that there was to be a liquidation and not a reorganization in the sense of floating out of the trusteeship a viable operating company. For the most part they had previously ratified their status as stockholders by attending meetings or voting proxies and, in the case of preferred stockholders, by accepting dividends as late as April 1972. The great majority of all the so called defrauded stockholders have heretofore filed statements with the Trustee alleging their status to be that of stockholders. We submit that five years later is too late in the day for them to assume a different role.

Another equitable consideration inheres in the fact that the allegedly defrauded stockholders have other remedies not available to lenders, suppliers or workers, including actions against the members of former management, underwriters, broker dealers, accountants and others who they may claim committed the alleged frauds of which they complain.<sup>6</sup>

<sup>5</sup> except for a negligible few, six in number, totalling \$21,869.

<sup>6</sup> more specifically, claims under the Securities Acts not available to creditors.



"If the subscriber became a shareholder in consequence of frauds practiced upon him by others, whether they be officers of the bank or officers of the government, he must look to them for such redress as the law authorizes, and is estopped, as against creditors, to deny that he is a shareholder, within the meaning of § 5151, if, at the time the rights of creditors accrued, he occupied and was accorded the rights appertaining to that position." *Scott v. Dewese*, 181 U.S. 203, 213 (1901)

The so-called defrauded stockholders in the case at bar are pursuing such remedies.

The District Court's opinion gives a further cogent reason for subordination in the following language:

"If the claims of alleged defrauded stockholders are not subordinated to the claims of conventional general unsecured creditors, a wholly new element will have been created in the financial structure of business. No longer will creditors, whether banks, suppliers, or sub-contractors, be free as they now are to extend credit to the ordinary course of business on their presumed right to be accorded priority over the claims of investors and speculators in securities, without first obtaining a secured basis which will guarantee them a priority status in the event their customer defaults. Such a fundamental change in the financial structure of the business community is unwarranted in the absence of legislation designed to overturn the long established rule of absolute priority." (28a)

Legislation directly to the contrary is now to be found in § 510(b) of the Bankruptcy Reform Act of 1978, *supra*.

The reasoning of the District Court grows on one the more one reflects upon the inequitable effect of rescission claims of defrauded stockholders if allowed on a *pari passu* basis with orthodox and conventional creditors. The rescission doctrine would permit claims for inordinately large amounts because

rescission under the Federal Securities laws potentially permits a stockholder to claim much more than the debtor's original selling price of the stock. We do not have to go further than the situation in the case at bar to illustrate this point. The debtor made two public offerings of its stock. It received \$6 million as a result of its first offering in 1970 and \$19 million as a result of its second offering on July 31, 1971. The common stock, which was issued for \$16.50 per share, traded at prices as high as \$50 per share a few months later. As appears from footnote 1 to the opinion of the Court of Appeals, Appendix A annexed to petitioners' brief, 4a, of the \$39 million in total proceeds of the two offerings, the debtor realized \$25,100,000. The loss to shareholders, taking account of intermediate market fluctuations in excess of the offering prices, while difficult to estimate, could be as much as \$100 million (according to the estimate of petitioners' counsel) (7a).

If the estimate of petitioners' counsel is correct, the claims of defrauded stockholders would approximate four times the amount of money which the debtor received for the sale of its stock. As stated by Messrs. Slain and Kripke in their much discussed article,<sup>7</sup>

"A creditor who has relied . . . upon the existence of a \$10 equity cushion under his claim against the issuer may see the \$10 equity cushion turn into a \$40 competing claim."

In such an order of things we ask, rhetorically, who is going to extend credit as a lender or supplier?

And, further, and to the same effect as the District Court's opinion, as one commentator put it,

<sup>7</sup> 48 N.Y.U.L. Rev. 261 (1973)



"A general creditor is entitled to a higher priority position because of the nature of the investment. When a creditor makes a loan after the stockholders have contributed capital to the corporation, the creditor relies upon the equity cushion of the stockholders. *The reliance need not be manifest—the stockholders are presumed to have knowledge of priority rights.* The court so held in *In re Irving Whitehouse Co.*" The court recognized the right of creditors to rely upon the shareholders' capital contribution. Credit is given to corporations with little or no knowledge of names of stockholders, but with confidence that, whoever they are, their rights in and to corporate property are subordinate to the rights of creditors. Thus, the creditor who has made a loan after stockholders or subordinated debt holders have invested in the corporation has a superior equity to the junior claimants, and should not be subjected to equal treatment with the rescinding security holders. (The Defrauded Investor, American Bankruptcy Journal, Vol. 50, 1976, p. 205.)" Emphasis added.

See, also, Slain and Kripke, *supra*.

The case of *Oppenheimer v. Harriman National Bank and Trust Co.*, 301 US 206 (1937), cited at p. 6 of the petition, is not in point. In national bank cases the statute requires a "ratable distribution on all claims" and vests no equitable powers in the controller making the distribution of assets to do otherwise. Thus, the situation in *Oppenheimer* was unlike a distribution under a plan comprehended by Chapter X of the Bankruptcy Act which requires a "fair and equitable" distribution. *Oppenheimer* was a national bank liquidation under the National Bank Act § 194, which reads in pertinent part as follows:

\* 293 Fed. 287 (9th Cir. 1923).

"... the controller *shall* make a ratable dividend of the monies so paid over to him by such receiver on *all* such claims as may have been proved to his satisfaction ... ." (Emphasis added.)

Here, however, we are dealing with a situation where the bankruptcy court in the exercise of its general equitable powers and those specifically granted by § 197 of the Bankruptcy Act has fixed "the division of creditors and stockholders into classes according to the nature of their respective claims and stock." In other words, in the *Oppenheimer* case the command of the statute, irrespective of considerations of fairness and equity, was plain and unmistakable. The distribution was to be, in the words of the statute, "ratable." In the case at bar the District Court in the exercise of discretion on the totality of the facts presented, reached the conclusion that a ratable distribution would not be "fair and equitable."

As observed by the Court in *Atlantic Gypsum Co. v. Federal National Bank of Boston*, 76 F. 2d 59 (1st Cir. 1935),

"Liquidation of national banks is controlled by statute; ..."

A different statute from the one governing the case at bar.

The case of *Matter of Mobile Steel Co.*, 563 F. 2d 692 (5th Cir. 1977), cited at p. 11 of the petition, is not in point. In the first place it is a Chapter XI case while the case at bar is a Chapter X case. In the second place, the facts are entirely different from the facts involved in the case at bar.

**Conclusion**

The petition for a writ of certiorari should be denied.

Respectfully submitted,

**FRANK G. RAICHLE,**  
*Attorney for Respondent, Frank G. Raichle,*  
*Reorganization Trustee,*  
10 Lafayette Square,  
Buffalo, New York 14203,  
Tel.: 716-852-7587.

Johnson, Reif and Mullan, P.C.,  
Byron Johnson,  
*Of Counsel.*

DEC 29 1978

MICHAEL RODAK, JR., CLERK

IN THE

**Supreme Court of the United States**

**NOVEMBER TERM, 1978**

**No. 78-869**

In the Matter of

STIRLING HOMEX CORPORATION,

*Debtor.*

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY,  
HARRY E. JONES, ALECK GOLDBERG, as Custodian for MARK  
GOLDBERG, and MRS. D. WINDSOR DIXON,

*Petitioners,*

—versus—

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN FIRST  
BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MAN-  
HATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF  
CHICAGO; MARINE MIDLAND BANK; THE TRAVELERS IN-  
DEMNITY COMPANY; and THE SECURITIES AND EXCHANGE  
COMMISSION,

*Respondents.*

**PETITIONERS' REPLY BRIEF**

ROBERT B. BLOCK

*Attorney for Petitioners*

295 Madison Avenue

New York, New York 10017

(212) 532-4800

POMERANTZ LEVY HAUDEK & BLOCK

MILBERG WEISS BERSHAD & SPECTHRIE

BADER & BADER

of New York City,

*Of Counsel*

December 29, 1978



# TABLE OF CITATIONS

PAGE

## Cases

<i>American Surety Co. v. Bethlehem Bank</i> , 314 U.S. 314 (1941) .....	3
<i>Bizzell v. Hemingway</i> , 548 F. 2d 505 (5th Cir. 1977) .....	4
<i>Caplin v. Marine Midland Grace Trust Co. of New York</i> , 406 U.S. 416 (1972) .....	3
<i>Carter v. Bogden</i> , 13 F. 2d 90 (8th Cir. 1926) .....	2
<i>Cartridge Television, Inc., In the Matter of</i> , 535 F. 2d 1388 (2d Cir. 1976) .....	4
<i>Case v. Los Angeles Lumber Products Co.</i> , 308 U.S. 106 (1939) .....	3
<i>City of New York v. New York, New Haven &amp; Hartford Railroad Co.</i> , 344 U.S. 293 (1953) .....	3
<i>Crimmins, Frank J., In the Matter of</i> , 406 F. Supp. 282 (S.D.N.Y. 1975) .....	4
<i>Duban v. Pro-Tech Programs, Inc.</i> , 441 F. Supp. 467 (S.D.N.Y. 1977) .....	4
<i>F.D.I.C. v. American Bank Trust Shares, Inc.</i> , 412 F. Supp. 302 (D. So. Car. 1976), vacated and remanded, other issues, 558 F. 2d 711 (4th Cir. 1977) .....	2
<i>Groenleer-Vance Furniture Co., In re</i> , 23 F. Supp. 713 (W.D. Mich. 1938) .....	2
<i>Oppenheimer v. Harriman National Bank &amp; Trust Co.</i> , 301 U.S. 206 (1937) .....	3
<i>Scott v. Abbott</i> , 160 Fed. 573 (8th Cir.), cert. den. 212 U.S. 571 (1908) .....	2

*Statutes*

## Bankruptcy Act

Chapter X, 11 USC § 501 et seq. ....	2
§ 17(a), 11 USC § 35(a) .....	4
§ 63(a), 11 USC § 103(a) .....	4
§ 106, 11 USC § 506 .....	4
§ 174, 11 USC § 574 .....	3
§ 221(2), 11 USC § 621(2) .....	3
§ 371, 11 USC § 771 .....	4

Bankruptcy Reform Act of 1978, Pub. L. No. 95-598,  
93 Stat.—

§ 510(b) .....	2
----------------	---

## National Bank Act, 12 USC § 21 et seq.

12 USC § 194 .....	3
--------------------	---

IN THE

**Supreme Court of the United States****November Term, 1978**

No. 78-869

---

In the Matter of  
STIRLING HOMEX CORPORATION,

*Debtor.*


---

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY,  
HARRY E. JONES, ALECK GOLDBERG, as Custodian for MARK  
GOLDBERG, and MRS. D. WINDSOR DIXON,

*Petitioners,*

—versus—

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN FIRST  
BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MAN-  
HATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF  
CHICAGO; MARINE MIDLAND BANK; THE TRAVELERS IN-  
DEMNITY COMPANY; and THE SECURITIES AND EXCHANGE  
COMMISSION,

*Respondents.***PETITIONERS' REPLY BRIEF**

The briefs of Trustee Raichle and of Chemical Bank and The First National Bank of Chicago, the only ones thus far served on petitioners, have no answer to our submission that equitable subordination of claims of innocent creditors is without precedent and that authority in this Court and in appeals courts in other circuits is all to the contrary. Instead, respondents urge that the question presented involves facts and complications which are unmentioned in the petition (as well as being disregarded in the opinions below).

Respondents' points are specious.

## Response To Trustee Raichle

### 1.

The Trustee, br. p. 2, suggests that the District Judge's "discretionary" subordination of petitioners' claims is based on facts and evidence peculiar to this proceeding.\* In actuality the opinions below amount to judicial declarations that, in any Chapter X liquidation-reorganization, fraud claims, for no reason other than that they are asserted by present or past stockholders, rank below all other unsecured claims.

### 2.

In relying on § 510(b) of the Bankruptcy Reform Act the Trustee, br. p. 4, conveniently overlooks that it does not take effect until October 1, 1979 and then only with the strongest possible saving clause for pending proceedings; pet. p. 5. To establish that § 510(b) "is merely a codification of existing law" the Trustee, br. pp. 5-6, resorts to inapposite citations: *F.D.I.C. v. American Bank Trust Shares, Inc.*, 412 F. Supp. 302 (D. So. Car. 1976), vacated and remanded, other issues, 558 F. 2d 711 (4th Cir. 1977), was a receivership, not a bankruptcy; in *Carter v. Bogden*, 13 F. 2d 90 (8th Cir. 1926), and *In re Groenleer-Vance Furniture Co.*, 23 F. Supp. 713 (W.D. Mich. 1938), the claimant-stockholders were not innocent of fraud like petitioners but themselves had overreached the debtor; and the rationale of *Scott v. Abbott*, 160 Fed. 573 (8th Cir.), cert. den. 212 U.S. 571 (1908), that stockholders were estopped to assert fraud claims against the debtor because its recreant officers were *ex officio* the agents of the stockholders, was implicitly

\* In similar vein the Banks' brief, pp. 8-13, presents a lengthy Statement of the Case, virtually none of which is germane either to the reasoning below or the issue presented by the petition.

rejected twenty-nine years later when this Court allowed such claims on a parity basis, *Oppenheimer v. Harriman National Bank & Trust Co.*, 301 U.S. 206 (1937).

### 3.

The Trustee, br. pp. 10-11, tries to distinguish *Oppenheimer, supra*, on the ground that it arose under the National Bank Act, 12 USC § 194, which calls for "ratable" distribution, as against Chapter X of the Bankruptcy Act, §§ 174, 221(2), 11 USC §§ 574, 621(2), which provides for "fair and equitable" distribution. But "ratable" in the Bank Act means "just and equal" . . . through the operation of familiar equitable doctrines." *American Surety Co. v. Bethlehem Bank*, 314 U.S. 314, 316 (1941). Compare *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 115-116 (1939); *Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416, 436 n.2 (1972). The ultimate standard under both statutes is the same.

### 4.

According to the Trustee, br. p. 7, petitioners, "except for a negligible few," waited too long to assert their claims. The suggestion underlying this statement is that a bar order obtained by the Trustee in December 1972, soliciting claims "of whatever character . . . other than those founded on . . . shares of stock", encompassed stockholders' fraud claims.\* Petitioners' position has been that this verbiage was not adequate notice that such claims were about to be barred, and that they have yet to be called for. See *City of New York v. New York, New Haven & Hartford Railroad Co.*,

\* The order is more fully referred to in the opinion below; pet. 7a, n.5, 2d ¶.



344 U.S. 293, 297 (1953). Notwithstanding extensive argument of this question, the District Judge, pet. 24a, left it unmentioned, and the court below, pet. 7a, n.5, 2d ¶, declined to discuss it.

**Response To Chemical Bank and the  
First National Bank of Chicago**

The Banks' main effort, quite unlike the Trustee's, is to justify subordination of petitioners' claims on the theory, br. p. 14, "that claims such as those asserted by Petitioners are neither provable nor allowable in a liquidation bankruptcy proceeding." The Banks, br. p. 14, cite four cases for this proposition: *Bizzell v. Hemingway*, 548 F. 2d 505 (5th Cir. 1977), and *Duban v. Pro-Tech Programs, Inc.*, 441 F. Supp. 467 (S.D.N.Y. 1977), were both Chapter XI arrangements, while *In the Matter of Cartridge Television, Inc.*, 535 F. 2d 1388 (2nd Cir. 1976), and *In the Matter of Frank J. Crimmins*, 406 F. Supp. 282 (S.D.N.Y. 1975), were straight bankruptcies.

At most these cases stand for the non-provability of fraud claims under §§ 17(a), 63(a) and 371 of the Bankruptcy Act, 11 USC §§ 35(a), 103(a) and 771, applicable in such proceedings. Those provisions, hence those citations, have no application to a Chapter X proceeding. Section 106 of Chapter X, 11 USC § 506, which the Banks omit to mention, defines "claims" to "include all claims of whatever character

... whether or not such claims are provable under section 63 of this Act . . ."; the same section defines "creditor" as "the holder of any claim." The Court of Appeals, pet. 12a-13a, assumed, for purposes of its opinion, that petitioners are creditors. The Banks have no effective authority to the contrary.

Dated: December 29, 1978

Respectfully submitted,

ROBERT B. BLOCK  
Attorney for Petitioners  
295 Madison Avenue  
New York, New York 10017  
(212) 532-4800

POMERANTZ LEVY HADEK & BLOCK  
MILBERG WEISS BERSHAD & SPECTHRIE  
BADER & BADER  
of New York City,  
Of Counsel.